Does This Stock Prove That Money Grows on Trees?

Description

Founded in 1955, **West Fraser Timber Co. Ltd.** (TSX:WFT) is now one of the largest lumber producers in North America. After going from $17 per share in 2010 to $65 per share today, long-term investors in this stock are starting to believe that money really does grow on trees.

Is West Fraser Timber your opportunity to build wealth by growing trees?

Pay attention to this factor

West Fraser Timber bills itself as a “diversified wood products company,” but it’s important to understand what that means.

Today, West Fraser operates around 45 manufacturing facilities in Western Canada and the southern United States. The company’s main product is milled lumber—primarily made from spruce, pine, and fir trees—but it also manufactures more value-add products like wood paneling, pulp, newsprint paper, and wood chips.

Notably, West Fraser does *not* grow its own trees. It purchases the raw material from suppliers, positioning itself as the value-add part of the supply chain, turning unprocessed timber into usable products.

Why is this distinction so important?

As a middleman, West Fraser operates as a key node in the supply chain. Without them, timber would be useless and consumers would have few finished products worth buying. While that may sound attractive, it positions the company in a section of the industry most vulnerable to commoditization.

The dangers of commodities

While timber is a commodity, it’s difficult to replace quickly.

Take **Weyerhaeuser Co**, for example. Sure, the company is at the whims of timber selling prices, but upon further inspection, it has a huge moat. Trees can take decades to grow, and most commercially available timberland is already allocated to a few companies. Additionally, if selling prices aren’t attractive in any given year, the company can forgo foresting, opting to let its trees grow another year, becoming even more valuable.

West Fraser has no such protections. Building new mill capacity can be done in under 12 months, compared to 12 years or more for timber growing. If profits are attractive in the wood processing sector, expect competitors to move in. West Fraser’s recent operating results demonstrate these risks clearly.

In the third quarter of 2018, the company earned adjusted EBITDA of $339 million, leading to positive net income of $255 million. In the fourth quarter, adjusted EBITDA fell to just $68 million, resulting in a net income of *negative* $93 million.

Why the sudden shift? $170 million of the decrease was due to pricing changes, something West Fraser has no control over. $31 million stemmed from market differentials, which the company also has little control over. Only $35 million of the decrease was due to lower sales volumes, while an additional $35 million decrease came from higher corporate costs.

So from the third quarter to the fourth quarter, EBITDA fell by $271 million, of which only $70 million was under the company’s control. Clearly, West Fraser cannot dictate its own future; that’s driven mostly by market forces.

Are shares buyable?

Companies dealing with commodities see their stock prices swing wildly based on prevailing supply and demand dynamics. The most important factor to note, however, is that these forces are completely beyond the company’s control.

West Fraser is doing all it can to succeed in this difficult segment of the timber market, but I’d stick with stocks with more future power.

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Date
2025/07/03
Date Created
2019/03/07
Author
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